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Reporting finance subsidiaries in consolidated financial statements; Issues paper (1978 December 27)

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ISSUES PAPER

Reporting Finance Subsidiaries in Consolidated Financial Statements

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Introduction

1. A significant financing technique used by many companies is the formation of subsidiaries to finance sales of the companies' products. While the authoritative accounting literature permits excluding certain other types of subsidiaries from consolidation, this paper focuses solely on consolidation practices related to finance subsidiaries.

2. This paper describes the organization of finance subsidiaries, presents a summary of applicable authoritative accounting literature together with the division's understanding of present practice, and suggests that the Financial Accounting Standards Board add consideration of this topic to its agenda. The paper concludes with a discussion of the issues that the division believes should be considered in addressing the question of the presentation of finance subsidiaries in the consolidated financial statements of an enterprise.

3. No specific definition of a finance subsidiary is included in the authoritative literature.[1] The following

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[1] Regulation S-X (Rule 4-02) refers to "a subsidiary engaged in the business of...finance (which group includes similar activities such as factoring, mortgage banking and leasing, exclusive of subsidiaries with only non-financing leases)."

definition is used for purposes of this issues paper: A finance subsidiary is a subsidiary whose purpose is to (a) purchase receivables from affiliates, (b) to finance the sale of affiliates' products, including those made to or by franchises, or (c) to provide financing in some situations to unrelated parties, for example, by lease, installment sales contract, revolving account, or long or short term note.

4. Finance subsidiaries may be thinly capitalized, with the debt of the subsidiary guaranteed by the parent company. The parent often agrees to fund the subsidiary's operations in a manner so as to protect the subsidiary's creditors from loss. For example, the "sales price" of the paper from the parent or other affiliated companies sold to the finance subsidiary may be structured so that the subsidiary operates at a breakeven point (including bad debt expense). Also, the parent's or other affiliated companies' funding arrangements may include a commitment to repurchase receivables, provide direct subsidies, provide for adjusting the discount rate, fund the bad debt reserve (frequently in excess of the

historical loss experience), or agree to pay operating expenses. Variations of these funding arrangements include the maintenance by the parent or other affiliated company of specified financial ratios (such as earnings to fixed charges or working capital) and the maintenance of equity levels of the unconsolidated finance subsidiary. The parent or other affiliated company may also directly guarantee the debt of the finance subsidiary, or the sale of receivables to the finance subsidiary may be with recourse.

5. Some finance subsidiaries, however, receive no financial support from the affiliated group other than the group's equity investment. This type of finance subsidiary may finance primarily the sales of the affiliated group in competition with unaffiliated financial institutions.

<u>Background</u>

6. The basic conclusion of Accounting Research Bulletin No. 51 issued in 1959, which covers consolidation principles, is that "there is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies." ARB No. 51 provides guidance on which subsidiaries may not be consolidated on the basis that "presentation of financial

information concerning the particular activities of such subsidiaries would be more informative to shareholders and creditors of the parent company than would the inclusion of such subsidiaries in the consolidation." It states "for example, separate statements may be required for a subsidiary which is a bank or an insurance company and <u>may be preferable for a finance company where the parent and other subsidiaries are engaged in manufacturing operations</u> (emphasis added)." This last phrase provides the support to justify exclusion of finance subsidiaries from consolidation. The words "<u>may be preferable</u>" have been interpreted almost uniformly to mean "it is acceptable" not to consolidate finance subsidiaries.

7. Since 1959, both the number and relative size of finance subsidiaries that follow the permissive exclusion from consolidation allowed by ARB No. 51 have increased. The increase in finance subsidiaries that are not consolidated appears, in part, to be related to a desire to improve balance sheet relationships by removing large amounts of debt related to the receivables serviced by the finance subsidiaries. The division believes that the propriety of the provision of ARB No. 51 that permits exclusion of finance subsidiaries from consolidation should be reconsidered now, because of the number and size of unconsolidated finance subsidiaries

presently in existence. It believes the reconsideration should not await reconsideration of the entire subject of consolidation.

Present Practice

8. The financial statements of a substantial number of finance subsidiaries are not included in the consolidated financial statements of the parent. The investment in the finance subsidiary is typically accounted for under the equity method in accordance with APB Opinion 18. Many companies present either separate financial statements of unconsolidated finance subsidiaries or condensed financial statements or summarized financial data concerning unconsolidated finance subsidiaries in the notes to the consolidated financial statements, although no specific disclosures are required by authoritative literature. Paragraph 21 of ARB No. 51 indicates that "where the unconsolidated subsidiaries are, in aggregate, material in relation to the consolidated financial position or operating results, summarized information as to their assets, liabilities and operating results should be given in the footnotes or separate statements should be presented for such subsidiaries, either individually or in groups, as appropriate." SEC registrants are required by Rule 403 of Regulation S-X and Instructions 3 to 5 for schedule 10K to present separate financial statements for

each significant subsidiary "which in the aggregate meets the tests of a significant subsidiary in the business of...finance which group includes similar activities such as factoring, mortgage banking and leasing, exclusive of subsidiaries with only nonfinancing leases."

Basic Issue

9. The basic issues are (a) Should ARB No. 51 be amended to eliminate the ability to exclude finance subsidiaries from consolidation and, if not, (b) should ARB No. 51 be amended or interpreted to provide criteria to identify finance subsidiaries that should be consolidated?

Factors to be Considered in Resolving the Basic Issue

10. The following questions should be considered in resolving the basic issues (the discussion under each question presents the factors the division believes bear on the question):

A. Are users provided better information if finance subsidiaries are not consolidated?

A basic presumption for an appropriate presentation of companies under common control is consolidation. Consolidation has been a cornerstone principle in the development of financial statements that are not only meaningful but that permit the user to obtain an overall picture of an entity's combined operations.

B. <u>Would a requirement that finance subsidiaries be consolidated allow for adequate disclosure of matters unique to these subsidiaries</u>? One of the major objections to the consolidation of finance subsidiaries is that required consolidation would provide less rather than more information to the reader. However, many believe that quantity of information provided is not an appropriate basis for the selection of a method of presentation. The objective should be to present relevant information in the most meaningful way. In any event, consolidation of finance subsidiaries would not preclude the continued presentation of separate financial statements of finance subsidiaries by many entities. Consolidation of finance subsidiaries would, therefore, make the consolidated statements more meaningful without a sacrifice in detail or quantity of information presented.

C. <u>Should uniqueness of operations, including the different risks in finance activities, justify exclusion from consolidation</u>? Many believe that informing the users of financial statements of an entity's diverse activities with their attendant risks is accomplished, at least for publicly held companies, by the disclosures required by FASB Statement No. 14, Financial Reporting for Segments of a Business Enterprise.

D. Does the failure to include assets and liabilites that are owned or controlled by an entity from its consolidated balance sheet result in an incomplete presentation? Many believe that to present an entity's consolidated financial position informatively, all assets and liabilities should be included, particularly those that could potentially influence an investor and creditor in their evaluation of the company's overall financial position and debt capacity.

E. Would consolidation result in improved comparability among companies, for example, companies that finance receivables through subsidiaries and those that carry their receivables themselves? Accounting for similar transactions in a similar manner is considered to be desirable; transactions should be accounted for in diverse ways only if the circumstances are dissimilar enough to warrant it. Many believe that the circumstances described are not dissimilar enough to warrant an accounting treatment for finance subsidiaries different from that for companies that finance their receivables themselves.

F. <u>Would technical problems arise from consolidating an entity's balance sheet that otherwise is presented in an unclassified fashion</u>? For example, is it appropriate to consolidate the unclassified balance sheet of the finance subsidiary with the classified balance sheet of the parent or to present the income (loss) from the finance subsidiary on a one line basis while fully consolidating the balance sheet?

<u>Subissues</u>

II. If finance subsidiaries should not all be permitted to be excluded from consolidation, should some nevertheless have that permission? If so, should specific guidance be given as to the circumstances under which finance subsidiaries should not be consolidated?

A. Should a distinction be made between those finance subsidiaries that primarily finance the paper of their parent company and affiliates and those that finance a substantial or major amount (in relation to total financing) of paper of unaffiliated third parties?

B. If such a distinction is appropriate, should a franchised dealer be considered an "unaffiliated third party?"

C. If the distinction is made along the lines of "A," should the decision be based on the percentage of paper financed for entities other than the parent or its affiliates? If so, what should be the percentage?

D. Should a distinction be made based on a direct or indirect guarantee of the subsidiary's debt by the parent company?

The following factors appear relevant to the above subissues:

A. Finance subsidiaries that deal primarily in paper originated by the parent company or one or more of its subsidiaries are an integral part of its operations. The ability to provide financing for the company's customers represents a marketing service. The arguments of separate and unique activities is not persuasive for those cases since the circumstances are similar to the transfer of accounts receivables of a manufacturing company to a subsidiary.

B. If a percentage test is considered appropriate, there is a possibility that unrelated finance subsidiaries may exchange paper to be serviced in order to meet the percentage guides specified.

C. Debt guarantees are not normally a factor in the determination of an appropriate accounting principle. To the extent debt guarantees exist, they may be viewed as additional evidence of control and risk potential, but not as a determining factor.

12. If some or all finance subsidiaries are to be consolidated, the term "finance subsidiary" should be more precisely defined. For example, should all or any of the following qualify?

Leases:

A. A company that services only finance lease receivables generated by its affiliates.

B. A company that services only finance lease receivables generated only partly or not at all by its affiliates.

C. A company that services both finance and operating lease receivables generated only by its affiliates.

D. A company that services both finance and operating lease receivables generated only partly or not at all by its affiliates.

E. A company that services only operating lease receivables generated by its affiliates.

F. A company that services only operating lease receivables generated only partly or not at all by its affiliates.

Other Receivables:

A. Companies that service conditional sales contracts, receivables, and chattel mortgages, whether generated solely, partly, or not at all by affiliates.

13. If the present guidance contained in ARB No. 51 permitting nonconsolidation of finance subsidiaries as a free alternative is considered to be appropriate, should additional guidance be provided as to required disclosures? The alternatives are:

A. Presentation of summarized financial information of the subsidiary if its activities are material to those of the consolidated group. This approach appears to be the present practice.

B. Presentation of complete financial statements of the subsidiary if its activities are material to those of the consolidated group. This approach is a present requirement of Regulation S-X of the Securities and Exchange Commission.

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Advisory Conclusions

14. The following are the conclusions of the accounting standards division on the basic issues presented in paragraph 9:

- Should ARP No. 51 be amended to eliminate the ability to exclude finance subsidiaries from consolidation?

  The division voted 6 yes, 9 no.

- Should ARB No. 51 be interpreted to provide criteria to specify those finance subsidiaries that should be consolidated?

  The division voted 12 yes, 2 no, one undecided.

- Should present practice remain unchanged?

  The division voted 0 yes, 13 no, one undecided.